

CHAPTER ONE

INTRODUCTION

1.0 Introduction to Islamic Banking

Mid Ghamr Local Savings Bank which was established in 1963 in a provincial rural centre in the Nile Delta of Egypt, is the first Islamic Bank in the world. Nowadays, Islamic banks not only operate in almost all Muslim countries but have also extended their wings to the Western world to serve both Muslim and non-Muslim customers.

There is evidence to indicate that the development of the Islamic banking system started from the time of the Prophet. One of the most important events relating to the interest was the revelations which prohibit Muslims from associating themselves with *riba* (interest).

Like any other Muslim country, the move towards establishing an Islamic bank in Malaysia was initiated by private parties. The first formal request was made during the Bumiputera Economic Congress in 1980. This Congress passed a resolution which required the government to allow the Pilgrimage Board (Tabung Haji as presently called) to establish an Islamic bank. In another seminar which was held in 1981 at the National University of Malaysia, the participants requested the government to promulgate special law which would allow the setting up of a new bank based on Islamic principles. In line with these requests, the government, on July 30, 1981 appointed a National Steering

Committee to study both the operations of the Faisal Islamic Bank of Egypt and the Faisal Islamic Bank of Sudan (Connors, 1988).

The Islamic Banking Act, 1983 which was gazetted on March 10, 1983 and came into effect on April 7, 1983 paved the way for the establishment of Islamic banking in Malaysia. This Act provides the Central Bank of Malaysia with powers to supervise and regulate Islamic banks in Malaysia.

The first Islamic bank, Bank Islam Malaysia Berhad (BIMB) was incorporated on March 1, 1983 and commenced operations on July 1 of the same year. However, the government does not have any intention to Islamise of the entire financial system. On the contrary, it was the long-term objective of the Bank Negara to create an Islamic banking system parallel to the conventional system (Sudin Haron, et.al. Islamic banking system).

In order to achieve the objective of an Islamic banking system (Bank Negara Malaysia, 1994), the system should have :

- (i) A large number of players
- (ii) A broad variety of instruments, and
- (iii) An Islamic inter-bank market

In the process to increase the number of players in the system, rather than allowing a new Islamic bank to operate, Bank Negara has introduced a scheme known as Skim

Perbankan Tanpa Faedah or Interest-Free Banking Scheme .Under this scheme often known as “Islamic windows” all financial institutions are given an opportunity to introduce Islamic banking products.

Bank Negara is also actively involved in formulating and establishing banking products whose operations do not violate Shariah principles. By the beginning of 1993, a total of 21 Islamic banking products were successfully developed by Bank Negara (Bankers Journal Malaysia, June 1993).

The first phase of Interest- Free Banking Scheme (IFBS) was launched on a pilot basis on March 4, 1993 by the Finance Minister, Dato’ Seri Anwar Ibrahim. The three largest domestic commercial banks which participated were Bank Bumiputra Malaysia Berhad (BBMB), Malayan Banking Berhad (MBB) and United Malayan Banking Corporation (UMBC). The three banks were allowed to open interest-free counters to offer Islamic Banking services to their clients.

The second phase of the Interest-Free Banking Scheme (IFBS) was launched on August 21, 1993 whereby 10 additional financial institutions joined the scheme after the first phase received a lot of positive responses especially from the depositors.

At the end of 1996, a total of 49 financial institutions participated in the scheme. They comprised 25 commercial banks, 21 finance companies and 3 merchant banks.

In January, 1994 the Islamic inter-bank market was introduced in the Malaysian financial system. This market consist of three elements namely ;

- (i) Islamic inter-bank investments
- (ii) Inter-bank trading in financial instruments and
- (iii) Islamic inter-bank cheque clearing system.

1.1 Principles of Islamic Banking

According to Ziauddin Ahmed et.al (Money and Banking in Islam), to charge interest from someone who is constrained to borrow to meet his essential consumption requirements is considered an exploitative practice in Islam. The charging of interest on loans taken for productive purposes is also prohibited because it is not an equitable form of transaction. The operation of a production process puts together several factors of production and involves various risks. As a matter of fact, all the production factors (capital, labour, land and entrepreneurship) collectively bear the risks and should therefore share the profit and / or the loss. However, *riba* seems to guarantee the owners of capital a fixed and positive returns (in the form of interest), irrespective of whether the project is successful or not. If an entrepreneur borrows money to carry out a project, the lender is assured of the return of interest, irrespective of whether the project is successful or not. The entrepreneur alone will have wasted not only his efforts and obtained nothing but more importantly, he will still be burdened with paying back the capital sum together with the accrued interest. Therefore, when there is an investment in a productive

undertaking, the quantum of profits that may accrue is not known at the beginning of the project and there is also the possibility of making losses in the long- run.

The charging of a fixed and pre-determined rate of interest on loans for productive purposes cannot therefore be morally justified. Justice demands that provider of financial capital should share the risk with the entrepreneur who wishes to make his project viable and profitable.

Thus, there is a basic difference between Islam and capitalism in regard to the treatment of financial capital as a factor of production. In the capitalistic system, financial capital is treated at par with labour and land, each being entitled to a return irrespective of profit or loss. However, in Islam, financial capital is treated at par with the entrepreneurship.

Therefore, the most striking feature of Islamic banking is that unlike conventional banking, it is totally interest free. Payment and receipt of interest is prohibited in Islam, regardless of the rate of return or the purpose of the financial transactions.

By disallowing interest and permitting profits, the shariah has developed two (2) specific forms of business arrangement under the profit and loss sharing system, **mudharabah** and **musyarakah** as means of sharing profits and losses without charging interest .

However, if equity participation under the profit and loss sharing scheme is not applicable, then the Syariah Law does allow the fixed-rate terms financing under the term-financing and trade-financing.

The three important principles that is desired and being practice in Islamic banking are as follows :

(i) The compliance of Syariah (Islamic Law)

This is to ensure the permissible transactions are interest- free and do not invest in unlawful forms of investment.

(ii) The principle of fairness to mankind

Since Islam is a religion that offers a way of life, it always refer to an equitable and quality life. In other words, justice in the Islamic value system requires that the financier, like the entrepreneur must participate in the risks of business by sharing in the ultimate outcome of the business, be it a profit or loss.

(iii) The principle of true and fair view

This refers to the substance of the transaction. As such, the contract being concluded must be of a buyer-seller relationship or partnership in nature. The principles of Islamic business must comprise of honesty and trade is to be conducted in a faithful and trustworthy manner (Ahmad,1994)

1.2 General Differences Between Conventional Banking and Islamic Banking

The foundations of the philosophy of Islamic banking are those principles which have been revealed in the Quran and the Hadith which requires Muslims to uphold justice and virtue, serve as principles which guide Islamic banks in managing their affairs. In the process of conducting business, Islamic banks seek to bring about a lasting balance between earning and spending in order to achieve a betterment of the whole community.

In dealing with their customers, Islamic banks are expected to conduct the transactions for the benefit of both, i.e. the banks as well as the customers and uphold the concept of justice. Therefore while conventional banking are likely to place profit as their primary objectives, Islamic banks have to incorporate both profit and morality into their objectives. The general differences between conventional banking and Islamic banking are summarized in Table 1.

Table 1 : General differences between conventional banking and Islamic banking

Conventional banking	Islamic banking
Interest	
Interest is fixed using the Base Lending Rate (BLR) plus a predetermined interest margin during the negotiation and is not based on any profit or loss of the bank. This interest rate moves whenever there is a movement in the BLR.	Allocation of profit ratio is fixed during negotiation and it is based on profit and loss of the bank. This profit ratio is fixed throughout the tenure of the loan.
The amount of interest received or paid is based on the percentage of predetermined interest rate and the principal amount involved.	The amount of profit received or paid is based on the percentage of profit sharing ratio on the profit earned from the productivity of the investment.
Payment and receipt of interest is fixed as promised without any consideration whether the investment by the bank is profitable or not.	Profit sharing is entirely based on profit generated from the productivity of the investment. If the investment is not profitable, then risk will be shared either by the depositors of the bank.
Payment and receipt of interest to depositors is fixed whether the banks profit is increased or decreased.	Payment of profit to depositors will be increased whenever profit from the investment increased or vice-versa.
Collection or payment of interest is against the Syariah principles.	Receiving and allocation of profit is permissible in the Syariah.
Extra charges/interest will be charged on the overdrawn account.	Any overdrawn is based on the Syariah concept of Al-Qard Hassan. No interest is imposed on the excess amount.
Price of financial capital of investment is interest.	Price of financial capital of investment is profit or loss.
Utilisation of funds	
No consent from customers is required to utilize their funds for investment purpose.	Consent from customers is required to utilize their funds for investment purpose.
Scope of financing	
No restriction on the scope of financing activities.	Scope of financing activities is limited to activities which are in line with the Syariah Principles.

Table 1 above clearly shows that the profit and loss principle adopted by Islamic banks in its financing activities is a risk-based financing approach as the profit earned or loss made by the bank is heavily dependent on the outcome of the business venture. Furthermore, it is unlikely that entrepreneurs who require financing for a profitable and viable project would seek financing under Islamic banking as they would have to share their profit with the bank. Therefore, the entrepreneurs would prefer a fixed interest-based financing knowing that the profitability of the project is almost certain.

However, entrepreneurs who are uncertain with the outcome of their projects, will seek financing from the Islamic bank because when the project is making loss, the bank will bear the loss solely or according to capital contribution. Therefore, likelihood of Islamic banks landing projects which the outcome is less certain to be determined at the onset is very high as the entrepreneur would prefer to transfer the risk of failure to the Islamic bank.

However, the market for the Islamic products are not confined to Muslims as any rational individuals or institutions, can opt for Islamic banking that best serve their interest.

1.3 Objective of The Study

1.3.1 General Objective

The general objective of the study is to provide new and practical insights into project financing undertaken by Islamic banks. In this paper, the term Islamic banking is used to denote Islamic banking operations undertaken by Bank Islam Malaysia Berhad (BIMB) and the commercial banks that participated in the interest-free banking scheme, often called the Islamic windows.

1.3.2 Specific Objective

The specific objectives of the study are as follows:

Firstly, the study aims to assess the current level of Islamic project financing and its associated growth.

Secondly, the study also attempts to identify problems faced in the implementation of Islamic project financing under the Mudharabah and Musyarakah concepts.

Thirdly, the study aims to demonstrate with a real life case study the costs of financing under Islamic banking as compared to conventional banking under conditions of high and low interest rates.

Finally, to demonstrate the use of Islamic asset securitisation in project financing.

1.4 Significance of The Study

There are three primary contributions of this study:

Firstly, this research intends to extend the previous research done on Islamic Banking. In review of the literature, there are not many researches done on project financing under Islamic banking, partly because Islamic banking is generally considered new to the majority of the businesses in Malaysia. Therefore, this study could also serve as a basis for future research on project financing under Islamic banking.

Secondly, this study intends to highlight the level of compliance of Islamic Banking in Malaysia with regards to Bank Negara's directive to increase total deposits and loans in the banking system by 5 % under the 7 th Malaysia Plan (1996-2000) to 20 % under the 8 th Malaysian Plan (2001 – 2005).

Thirdly, the study is important as it raises the awareness of Muslims and non Muslims in Malaysia of the Islamic banking principles namely Interest-Free Banking System (IFBS).

Fourthly, to promote awareness among potential borrowers that projects can be financed using Islamic banking principles under the various financing arrangements.

1.5 Scope of The Study

As at December 1999, there are a total of 25 commercial banks in Malaysia, comprising of locally incorporated domestic banks and foreign banks. Out of these 24 banks, only 19 banks offer Islamic Banking products. Only 8 banks from these 19 banks offer project financing or term financing. Included in the 8 banks are Bank Islam Malaysia Berhad, a full fledged Islamic Bank, and OCBC Bank (M) Berhad which is the only locally incorporated foreign bank offering term financing. In view of the above, only eight banks were selected for the study.

The study will be based on empirical data, obtained from interviews conducted on seven Islamic banking division of commercial banks and Bank Islam Malaysia who are providing equity- based project financing under the profit and loss sharing scheme.

1.6 Research Approach

The research is of exploratory type which intends to identify the type of applications, the influencing factors and problems experienced in regards of project financing under Islamic Banking. The research objectives will be addressed using primary data. The primary data was collected by conducting interviews using structured questionnaires.

The research was restricted to 8 banks, which is inclusive of a fully fledged Islamic Bank which is Bank Islam Malaysia Berhad , offering project financing or term financing.

Included in this research is OCBC Bank (M) Bhd, the only locally incorporated foreign bank offering term financing under Islamic Banking.

1.7 Research Instrument

The research instrument for the purpose of the study was developed through library research and feedback obtained from discussions with bank officers specializing in Islamic banking. It was highlighted that although the loan growth and number of customers has been on the increasing trend over the years there has been limited use of Musharakah form of financing within the Islamic based banks whereas the Mudarabah form of financing is not used at all. Currently the Musharakah form of financing is used primarily for government backed projects. There is no real effort being put to establish an economic system that ensures that the position of the financier and financee is protected to a certain degree. This is possible from using the Islamic form of financing whose objective is to establish justice between the financier and the entrepreneur by ensuring a positive return.

Based on the above, the study aims to answer the following questions :

- 1) What are the Islamic products available for project financing?
- 2) What are the factors and barriers that influences financing decisions made within the Islamic banking system?
- 3) What are the alternative forms of financing used?

- 4) The cost comparison between project financing under Islamic form of financing as compared to conventional form of financing.
- 5) To highlight the major constraints on effectively implementing Islamic Banking in Malaysia.

1.8 Limitation of The Study

The study was restricted to 8 banks who were offering project financing or term financing under Islamic Banking and one bank intending to offer project financing under Islamic Banking in the near future. The study did not cover the other banks who were offering other forms of Islamic Banking products but did not offer project financing. Therefore, the findings of this research is only limited to the banks who are offering project financing under Islamic banking and does not include the reasons why the other banks have not ventured into this form of financing.

1.9 Organisation of The Study

Chapter one intends to introduce the concept of Islamic banking and the research questions for the study. Also discussed are the issues related to the research, the significance, the scope, the approach and limitation of the study.

Chapter two provides review of literatures in relation to Islamic Banking – characteristics and services offered, the differences between Islamic and Conventional Banking ; and how Islamic Banking can be used for project and term financing.

Chapter three discusses the research methodology which includes the sampling design, sampling population, data collection methods and data analysis methods.

Chapter four provides analysis of the research findings and case studies to substantiate research findings.

Chapter five provides a summary of the research findings and conclusions. In addition, recommendation for future research and implication of the study were also discussed.